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Foreign Economic Trends and Their Implications for the United States

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Key Economic Indicators
(Millions of U.S. dollars unless otherwise noted)

	1986	1987	1988(est.)
Domestic Economy			
Population (millions)	9.6	9.9	10.2
Population Growth (%)	2.8	2.8	2.8
GDP (billions of 1975 sucres)	169.3	160.5	173.3
% change	3.2	-5.2	8.0
GDP in current dollars	10959	9345	10188
Per capita GDP in dollars	1136	944	999
Consumer Price Index % change	27.3	32.5	85.7
Production and Employment			
Labor force (thousands)	2950	3050	3150
Unemployment (avg. %)	10.4	10.8	11
Industrial Prod. % change	-1.7	0.2	0.7
Public Sector Surplus			
(billions of sucres)	-70.1	-188.3	-415
Percent of GDP	1.9	-5.1	-12
Balance of Payments			
Merchandise Exports (FOB)	2186	2017	2203
Merchandise Imports (CIF)	1631	2048	1614
Trade Balance	555	- 31	589
Current Acct. Balance	-548	-1187	-597
Foreign Direct Invest.	70	50	80
Foreign Debt (year-end)	8153	9393	9550
Debt Service Paid	1000	578	1811*
Debt Service Rescheduled	1005	0	112
Increased Arrears	160	738	314
Debt Service Ratio			
(payments as % of exp.)	45.7	28.7	82
Net Foreign Exchange			
Reserves (year-end)	-75	-151	-176
Avg. Exchange Rate	145	194	454
U.S.-Ecuador Trade			
U.S. Exports to Ecuador	595	615	680
U.S. Imports from Ecuador	1465	1266	1231
Bilateral Trade Balance	-870	-651	-551
U.S. Share of Ecuador's			
Exports (%)	67	63	56
U.S. Share of Ecuador's			
Imports (%)	37	30	31
U.S. Bilateral Aid (FY)	66.8	NA	NA
Economic aid	62.3	56.8	26.0
Military aid	4.5	NA	NA

- o Principal U.S. Exports (1988): Paper products, wheat, organic chemical products.
- o Principal U.S. Imports (1988): Shellfish, fruits and nuts, petroleum products.

* Scheduled only; actual payments are not available, but were probably about $1 billion (including $220 million under the Paribas oil-financing facility).

INTRODUCTION AND SUMMARY

The new government of Rodrigo Borja assumed office on August 10 and inherited a rapidly worsening economy. Inflation was accelerating, the fiscal deficit was estimated at nearly 16 percent of GDP, the free-market value of the sucre had plummeted, and the international price of oil had resumed its fall. Disbursements from the World Bank and the IDB had ceased because of arrearages in debt service and Ecuador's failure to comply with conditionality targets.

Twenty days after assuming office, the Borja government introduced a package of economic measures. Prices of some products supplied by the public sector -- especially fuel -- were increased, austerity was ordered for public-sector spending, and a tight monetary policy was introduced. At the same time, the official value of the sucre was devalued by 56 percent and the Central Bank resumed control of foreign-exchange transactions for private-sector trade. In the following months, some price-distorting subsidies have been reduced or eliminated, and tax reforms were introduced with the objective of achieving a balanced central-government budget in 1989. Negotiations with foreign creditors commenced slowly, but seem likely to proceed soon. The major uncertainty is how to deal with accumulated arrearages of more than $1 billion. An innovative debt rescheduling is vital to straightening out the long-term picture.

If current policies are maintained during 1989, the tight monetary policy and improved fiscal situation should reduce inflation from the 1988 level of 86 percent. The World Bank, Inter-American Development Bank, and International Monetary Fund are working closely with the Borja Government in the anti-inflation effort, and important disbursements should be possible shortly to support Ecuador's responsible adjustment program. Domestic demand will be very limited, as the monetary board is projecting only a 32 percent growth of M1, defined as currency and demand deposits. Under this recently announced monetary plan, real non petroleum economic growth is projected at only 1.6 percent -- substantially below the 2.8-3.0 percent rate of population growth. The government intends to make a special effort to stimulate growth in the agricultural sector. It should also make a greater effort to diversify exports, since petroleum has been a mixed blessing. In particular, the budget has depended too greatly on oil-export proceeds.

A. CURRENT ECONOMIC SITUATION AND TRENDS

Economic Growth

Preliminary government statistics indicate that real GDP (measured in volume terms) improved 8 percent in 1988, mainly due to recovery of crude petroleum output. The nonpetroleum sector grew slowly -- 1.5 percent -- substantially below the

rate of population growth. The manufacturing sector continued its stagnation of recent years (0.7 percent growth), while construction declined 6.8 percent. Growth of the key agricultural sector declined from recent levels, to only 3.8 percent.

GDP growth in 1989 is not likely to be very strong, with tight credit policies and import restrictions affecting both agriculture and manufacturing. The Monetary Board established a target of only 0.9 percent real GDP growth for 1989, and 1.6 percent growth for the non petroleum economy. Population growth is estimated at 2.8-3.0 percent. The following table represents the sectoral GDP breakdown, growth rates in volume terms for 1987 and preliminary rates for 1988.

Sector	% share of GDP	% growth 1987	1988
Agriculture and Livestock	16.1	7.4	3.8
Petroleum and Mining	7.4	-51.5	86.1
Manufacturing	18.7	0.2	0.7
Construction	4.9	1.4	-6.8
Others	52.9	0.8	2.0
Total GDP	100	-5.2	8.0

Petroleum

Crude oil production in 1988 totalled 110 million barrels, a 73 percent increase over 1987. Output average 301,000 barrels per day. This increase was due to recovery of the sector after production was reduced for six months in 1987 by an earthquake. Crude exports increased 65 percent, to 69 million barrels, of which 10.4 million barrels went to repay an in-kind loan from Venezuela after the quake. According to the Central Bank data, 16.1 million barrels were traded abroad for petroleum derivatives and LPG consumed domestically. Internal consumption, including this "bartered" amount, increased 32 percent to 47.5 million barrels, while 9.6 million barrels (crude equivalent) of derivatives were exported.

Petroleum exploration activities accelerated during 1988, with investment by foreign firms totalling nearly $200 million. Results so far have been somewhat disappointing, with about one-third of wells drilled hitting oil -- some of which was not in commercial quantities. Only two firms have found enough crude to begin planning production. A few others have found some positive indications, but apparently not enough to be commercial at this point. Most of the petroleum found by the foreign firms is heavier (14-23 API) than the currently exported Oriente crude (29.5 API). On the other hand, the state petroleum company, CEPE, has found commercial quantities of light crude in joint exploration with the Colombian firm ECOPETROL near the Colombian border. Furthermore, exploration in the southern Oriente is just getting under way, with the

first well in that area completed only at the end of 1988. President-elect Borja has publicly welcomed continued foreign investment in oil exploration, and Energy Minister Tamariz recently announced that new blocks may be available for exploration by foreign firms during 1989.

Energy Minister Tamariz announced in September that CEPE would exercise its contractural right to take over operation of facilities currently managed by Texaco. CEPE is to begin operation of the Trans-Andean pipeline in October 1989 and of the CEPE-Texaco production consortium in July 1990. Texaco's 38.5 percent equity stake in the consortium is not directly affected -- it will expire as per the contract in July 1992. The small refineries in the Santa Elena peninsula -- Anglo and Repetrol -- also are to revert to CEPE upon expiration of their contracts in 1989 and 1990, respectively.

The government plans to reorganize CEPE, seeking to provide it with the administrative and financial capability of handling these new responsibilities. Given the general inefficiency of public-sector firms in Ecuador, it is possible that CEPE will not be able to maintain petroleum output at the current level. Furthermore, although complete details of the reorganization are not yet known, it has been publicly reported that the new board of directors will include the employees' union Fetracepe and the engineers' union -- both of which are communist-dominated and advocate reduced production and the exclusion of foreign participation in the industry. Intentionally or not, it is possible that output will decline in 1989 from the 1988 level.

Fiscal Policy

During August, the new government announced that the 1988 fiscal deficit for the entire public sector would approach 491 billion sucres -- about 16 percent of GDP. The government then doubled domestic fuel prices, eliminated a 10-billion-sucre subsidy to wheat imports, and ordered austerity in government spending. Subsequently, it increased electric-power rates by 60 percent for industrial users and 40 percent for households. As a result, it appears the deficit may have been reduced to under 12 percent of GDP.

The 1989 budget announced for the central government in 1989 (accounting for about half of the public sector) is balanced, with expenditures and revenues each projected at 703 billion sucres. The government expects that tax reforms will produce a considerable improvement in income and sales tax collections. The rest of the public sector still is likely to run a deficit, but the announced intention is to finance that through loans from multilateral banks, rather than inflationary financing from the Central Bank. Budget projects, however, are notoriously inaccurate in predicting actual expenditures. New spending programs, including higher public-sector wages, are likely to be adopted during the year, and the projected revenue increases may be difficult to achieve while the economy is in a slump.

Monetary and Credit Policy

During the first half of 1988, the government boosted inflation by providing unprecedented levels of Central Bank financing to the public sector -- 36.8 billion sucres during the first 7 months of 1988, a 119 percent increase. This tap was turned off when the new government took office, with Central Bank credits to the government declining 1.1 billion sucres during the final five months of the year. M1 grew 52 percent during the year. The government appears determined to keep monetary growth below the rate of inflation as the main weapon deployed against that problem. What official credit is created appears destined principally for the agricultural and housing sectors.

Inflation

Inflation has been trending upwards, with the CPI increasing 85 percent during 1988. Monthly inflation peaked at 7.4 percent during September and declined to 5.3 percent in January. Higher food prices led the CPI, partly due to poor agricultural policies throughout the year, including a lack of credit for planting, mishandled import/export policies, and price controls reducing incentives to increase planting.

The Borja government announced a goal of reducing inflation to 30 percent during 1989. This, in fact, is the cornerstone of its stabilization plan, which is focussed almost exclusively on controlling inflation. The short-term plan to increase availability of food commodities includes selective price increases and extensive imports using U.S. Commodity Credit Corporation credits. The weekly pre-announced devaluation of the sucre (31 percent during 1989) also is intended to contribute to price stabilization. The principal tool to fight inflation, however, is the tight monetary policy; fiscal policy should also contribute, as the deficit is cut to 5-6 percent of GDP. Disbursement of up to several hundred million dollars in sectoral lending by the World Bank and IDB should permit adequate internal lending without adding to price pressures.

Foreign Exchange and Exchange-Rate Developments

According to revised Central Bank data, net international monetary reserves were negative $147.1 million on December 31, 1987, and declined to negative $319.7 million on July 31. This negative total is attributable mainly to balance-of-payments loans outstanding. When the Borja government took office, it reportedly found only $9 million of liquid reserves in the Central Bank. By year-end, however, the situation had recovered somewhat, with net reserves at minus $175 million.

The free-market value of the sucre declined to about 560 sucres per dollar in mid-July. During the second half of 1988 it strengthened, approaching 430 sucres per dollar in November before turning back around and ending the year at about 500. The 114 percent devaluation during the year exceeded inflation by about 30 points.

As part of its August 30 stabilization package, the government introduced a new foreign-exchange system. The official exchange rate was devalued to 390 sucres per dollar, from the previous rate of 250. That rate, initially devalued by 2.5 sucres per week and presently devalued 3.0 sucres per week, will result in 31 percent devaluation during 1989, roughly equal to the Ecuadorian government's target for inflation. Private-sector exporters are required to submit their dollar earnings to the Central Bank. The Central Bank keeps 10 percent of those dollars to improve its reserves and makes the remainder available to private-sector importers at 5 percent above the official rate. These dollars are provided twice-weekly, through financial intermediaries. A free market continues to exist for residual transactions.

In contrast to the previous system, the new one has worked fairly well, so far. During the final three months of 1988, more dollars were available to importers than were required by them. This, however, appears principally due to certain import restrictions and financing arrangements, and thus may not prove adequate. The relative strength of the sucre on the free market can be attributed, in part, to the success of the controlled market. The free market also was affected by the tight monetary policy, which reduced the sucres available for speculation and investment in dollars, and apparently led to some return of flight capital to provide working capital to local businesspeople.

To reduce demand for foreign exchange, the Borja government banned imports of almost all capital goods unless completely financed abroad. The prior deposit scheme was expanded to include transactions with the public sector; importers must deposit in a non interest-bearing account with the Central Bank, an amount in sucres of up to 160 percent of the value of the import for a period of 120 days. This requirement now can be avoided, however, if importers obtain foreign financing for at least 120 days. This proviso has led some importers to purchase dollars on the free market and to send these dollars abroad where they serve as guarantee for the extended letter of credit. In effect, this provided a 120-day margin before the Central Bank would have to provide dollars for imports -- and contributed to the apparent decrease in total imports during 1988.

Balance of Payments

As illustrated in the table below, the merchandise trade balance recovered to a significant positive amount in 1988 -- $729 million -- following the disastrous situation in 1987. The volume of petroleum exports recovered, but was partially offset by declining prices. Shrimp exports apparently ended the year

at about the 1987 level. Banana exports appear to have enjoyed a record year. Total private-sector exports increased $85 million over 1987, to $1.291 billion. Imports declined $532 million from the previous year, since the extraordinary imports related to the earthquake no longer were necessary and the effective ban on capital goods imports and other import restrictions (mentioned above) took effect. Scheduled interest payments nevertheless kept the current account negative. However, very little commercial-bank interest was actually paid, running up arrearages but avoiding the need for substantial new borrowing.

On the capital account, a financing facility led by Banque Paribas and linked to oil exports was repaid in full, as was the in-kind petroleum loan from Venezuela. Disbursements from multilateral agencies, principally the World bank, the IMF and the IDB, ceased after July, due to Ecuador's non-compliance with conditions, especially relating to the fiscal deficit. The capital account therefore was only slightly positive -- i.e., a minimal amount of additional real debt was incurred. The negative current account balance thus was offset principally by increasing arrearages.

Balance of Payments
(Millions of U.S. dollars)

	1987	1988 (est.)
Current Account	-1187	- 597
Trade Account	- 31	589
Merchandise Exports	2017	2203
Petroleum	821	976
Shrimp	383	380
Other	813	847
Merchandise Imports	2048	1614
Services Account	-1228	-1246
Exports	463	446
Imports	-1691	1692
Interest	817	782
Other	874	910
Net Transfers	10	60
Capital Account	369	578
Direct Investment	50	80
Net Borrowing	587	-172
Borrowing		1558
Med.Term		847
Amortization		-1730
Med Term		-942
Other	- 268	670
Change in Net Reserves	80	-25
New Arrearages (net)	738	315

Footnote: The petroleum loans from Venezuela and Nigeria are included under the capital account, with borrowing in 1987 and most of the amortization for these loans in 1988. Amortization of the Paribas oil facility also is included in the capital account for 1988, despite its original short-term nature. "Other" under the capital account includes some reschedulings and refinancings.

The balance of payments may show some improvement during 1989, if petroleum prices continue above the 1988 average and import demand is restrained either through direct controls or due to economic recession. It is doubtful, however, that private sector exports will improve significantly, especially with current exchange rates. Shrimp production has been trending down in recent months and is affected by new competitors from the Far East, as well as by negative weather conditions. The government has indicated that it would seek a standby agreement from the IMF, which would further facilitate the adjustment program for the balance of payments.

Debt

Ecuador's external debt (not including loans counted in foreign exchange reserves, but including new arrearages) only increased by $150 million during 1988, to about $9.6 billion. No significant new medium or long-term lending from commercial banks was available, and disbursements from multilateral banks virtually ceased after mid year.

Since January 1987, Ecuador has made only limited and occasional payments to service its commercial bank debt. By the end of 1988, approximately $1 billion of arrearages had accumulated. A preliminary formal meeting between the new government officials and the Bank Steering Committee was held in early December, and negotiations for a rescheduling agreement began in March. Government authorities insist that they are seeking a "non traditional" agreement, which would include debt reduction as well as extended repayment periods and reduced interest rates.

A Paris Club agreement reached on January 20, 1988, rescheduled $275 million of official bilateral credits, including 100 percent of principal and interest (due on loans made prior to the 1983 cut off) that was in arrears on December 31, 1987, and falling due during 1988 and the first two months of 1989. After falling behind on payments to multilateral financial institutions during the year, by the end of 1988 Ecuador became roughly current on them.

Despite the recovery of oil production and not making interest payments to commercial banks, Ecuador's foreign exchange resources were severely strained during 1988. Virtually all of the foreign exchange used for debt service, official imports,

and other official expenses comes from petroleum exports. A $220 million "oil-facility" loan was repaid during the first half of 1988, as was the bulk of the in-kind petroleum loan from Venezuela. Over $100 million were spent on exchange-market intervention in early 1988. On the income side, petroleum prices averaged about $12.65 per barrel -- more than 27 percent below the $17.50 projection used in preparing the 1988 budget.

The New Government

Rodrigo Borja was inaugurated President of Ecuador on August 10 for a four-year term. Borja heads the Izquierda Democratica (ID) party, which is affiliated with the Socialist International. Borja formed a coalition with the Christian Democratic (DP) party to create a center-left majority within the national legislature. The ID party includes activists ranging from moderates to marxists, but most of the cabinet appointments -- including the key ministries of government and finance -- are from the pragmatic center of the party. The Minister of Industry, Commerce and Fishing is from the DP, and the President of the Monetary Board and General Manager of the Central Bank are independents closely linked to the DP. Some representatives of the local business community, however, are concerned that ID leftists are located in important "second-rung" positions in the bureaucracy. The Ministers of Labor and of Education also were drawn from the left wing of the party.

The foreign policy of the Borja government has emphasized an effort to maintain good relations with all countries, while strengthening Ecuador's relationship with fellow Latin American countries. Thus, diplomatic relations with Nicaragua were established on Borja's first day in office, and his first trip abroad was to Caracas for the inauguration of the new Venezuelan President. At the same time, good relations have been maintained between Ecuador and the U.S. Government.

B. IMPLICATIONS FOR U.S. BUSINESS

Total U.S. exports to Ecuador may decline during 1989, as the total level of imports continues to be restricted. Financing terms will continue to be important -- under current rules, imports of most capital goods must have 100-percent foreign financing. If such financing is available -- and some may be arranged through large IBRD and IDB programs -- suppliers of capital and intermediate goods such as oil-field equipment, farm machinery, and industrial inputs should fare better than suppliers of finished consumer goods. Exports from the United States of commodities eligible for CCC financing should increase somewhat over the 1988 level.

The potential for sales to Ecuador appears greatest in the following sectors.

Petroleum industry: The state petroleum company CFPE is expanding its productive capacity, and 12 foreign consortia are carrying out exploration activities. Investment by these foreign firms may exceed $200 million during 1989.

Food processing and packaging equipment: The annual population growth of 2.8 percent and the government's continued efforts for exporting non traditional agricultural products require a considerable increase in food processing. About 85 percent of present industry operates with manual and low-volume production equipment. The need to improve present operating equipment and purchase new packing and packaging equipment is imperative.

Agricultural machinery: Agriculture continues to be one of the most important sectors in Ecuador's economy, as it continues to be the main source of employment, providing jobs for 49 percent of the population. Emphasis on increasing production of basic food products to meet local demand, plus the diversification of exports of non traditional agricultural products (exotic fruits, spices, and vegetables), will require a variety of machinery and equipment (irrigation equipment and tractors), raw materials (fertilizers and pesticides), and technical assistance.

Medical hospital and dental equipment: Health care service in Ecuador has been affected by the decline in the economy. The government has not been able to implement several health care priority projects. Health care facilities in both the public and private sectors need to replace obsolete equipment.

Safety and security equipment: Ecuador offers good market potential for the import of industrial safety equipment. The majority of industrial plants need safety equipment, thereby opening excellent opportunities for U.S. companies.

Telecommunications: The Ecuadorian telecommunications agency has an ambitious program for the rehabilitation, expansion, and installation of new telephone lines and telex systems. Best prospects include switchboards, telephone apparatus, and telex and telefax equipment.

Fishing equipment: The Ecuadorian fishing fleet is obsolete and needs upgrading. New fishing and processing machinery is needed. At least 100 new boats are required. The Andean Development Corporation located in Caracas has made some $25 million available for this purpose.

Mining and ore-processing machinery: The Ecuadorian mining industry is just beginning. Ecuador has recently started industrial gold exploitation from rivers. There are considerable reserves of copper, zinc, and cobalt, as well as precious metals (gold, silver, and platinum) and non metallics. This is a new area of development, and there is little infrastructure. All kinds of machinery and equipment are required. This, along with petroleum, is one of the sectors for which President Rodrigo Borja has stated that foreign investment is particularly welcome. On the other hand, the government has yet to clearly define its policies in this sector.

Refrigeration and air conditioning equipment: Air conditioning is needed year-round in the coastal areas, and refrigeration equipment is a continuing need. Most equipment is imported as local production does not fill demand.

Two fairs entitled "American Commercial Day" will be held as follows: November 1989 in Guayaquil; October 1990 in Quito. These events have proved to be an excellent promotional tool for U.S. goods and services. They are organized by the Commercial Section of the American Embassy in Quito, in conjunction with relevant local business groups.